United States Court of Appeals

for the Second Circuit

APPELLEE'S BRIEF

ORIGINAL

76-7166

United States Court of Appeals

FOR THE SECOND CIRCUIT

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SECOND CIRCUIT

Docket No. 76-7166

SAMUEL MALLIS and FRANKLYN KUPFERMAN,

Plaintiffs-Appellants,

against

FEDERAL DEPOSIT INSURANCE CORPORATION, EUROPEAN-AMERICAN BANK & TRUST COMPANY, FRANKLIN NATIONAL BANK and THE BANKERS TRUST COMPANY,

Defendants-Appellees.

APPEAL FROM FINAL JUDGMENT OF THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

BRIEF OF DEFENDANT-APPELLEE BANKERS TRUST COMPANY

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BRIEF OF DEFENDANT-APPELLEE BANKERS TRUST COMPANY

Questions Presented On Appeal

I.

A. Whether a pledgee of legended stock may maintain an action for fraud against a Bank under the anti-fraud provisions of the Securities & Exchange Act, where the Bank had merely received the securities as collateral for a loan in 1970, which was subsequently reduced, and returned to the pledgor upon the repayment of the loan in 1972.

B. Whether a pledgee has standing as a purchaser to institute an action under the anti-fraud provisions of the Security Act if the pledge arose from a separate and distinct transaction.

II.

Whether a judgment in a State court proceeding which held that Bankers Trust Company had no relationship with the pledgee Mallis and was free from wrongdoing precludes Mallis from relitigating the issues in Federal Court under the doctrine of collateral estoppel.

Counter Statement of the Case

This action was instituted by Samuel Mallis (hereinafter "Mallis") and Franklyn Kupferman (hereinafter "Kupferman") alleging *inter alia* that Bankers Trust Company (hereinafter "Bankers") was prohibited by the 1933 Securities and Exchange Act (hereinafter "the Act") from receiving a pledge of securities from Jerome and Judith Kates (hereinafter "Kates") in August, 1970, as collateral for a loan, and that by virtue of the Securities Act, Bankers was precluded from disposing of these securities except to the same Kates (App. 12a).[1]

The complaint further alleges that by virtue of Bankers wrongful transfer of securities to plaintiff, Mallis, in March, 1972 in return for which Bankers allegedly received $45,000 from Franklin National Bank (hereinafter "Franklin") the predecessor in interest of the FDIC, Bankers violated the Act (App. 12a).[2]

After an answer had been filed by Bankers on April 11 (App. 2a) and on motion to dismiss the third cause of action with respect to Bankers (App. 123a) the Court, Judge Milton Pollack, granted the motion in a memorandum opinion reported at 406 F. Supp. 7 (App. 176a-191a).

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[1] The first two Causes of Action in the complaint are with respect to the FDIC and European-American Bank. This brief does not address itself to that determination.

[2] App. references followed by the suffix "a" are to the appendix on appeal. The appendix did not reproduce Bankers' answer.

The Court dismissed the claim against Bankers for failure to state a claim upon which relief can be granted and for lack of jurisdiction over the subject matter of the controversy (App. 190a). The Court reasoned that the claim was barred to the (App. 185a):

> "plaintiffs who were not purchasers within the requirement of the *Birnbaum* doctrine. *Birnbaum* v. *Newport Steel Corp.*, 193 F2d 461 (2d Cir. 1952), as adopted in *Blue Chip Stamps* v. *Manor Drug Stores*, 43 U.S.L.W. 4707 (June 9, 1975), —— US. —— (1975).
>
> "The mere acceptance of a stock pledge as collateral in a privately negotiated transaction between borrower and lender does not of itself bring a transaction within the scope of the federal securities laws. See, e.g. *McClure* v. *First National Bank of Lubbock, Texas*, 497 F.2d 490 (5th Cir. 1974), *cert. denied,* 43 U.S.L.W. 3449 (1975); *Rosen* v. *Dick* (1974-75), CCH Fed. Sec. L.Rep. 94,786 (S.D.N.Y. Sept. 3, 1974)."

The Underlying Facts

Bankers is a commercial bank. In August, 1970, Kates, who was not a party to this action, applied to Bankers for a $50,000 loan (App. 126a). As collateral for the loan, Kates pledged to Bankers 40,384 shares of legended common stock of Equity National Industries, Inc. (hereinafter "Equity") (App. 132a, 126a). At that time everyone expected the loan to be repaid to Bankers by Kates, and the collateral returned to Kates. Kates reduced his indebtedness to Bankers from $50,000 to $45,000 by regular monthly payments (App. 133a). When the monthly payments ceased, a "work-out" arrangement was entered into whereby Kates and his wife signed a Confession of Judgment which was filed in court on July 20, 1971 as a lien against their real estate (App. 126a, 282a).

In February, 1972, Kates made various arrangements with Jack J. Arnold (hereinafter "Arnold") to sell to Arnold the 40,384 shares of Equity which had been previously pledged to Bankers, as well as 110,000 shares of common stock of Merck & Company at 60% of "the then existing market price" of Merck & Company (App. 25a-28a, 159a). In that agreement, Kates represented and warranted to Arnold that the Equity securities were "validly issued, duly authorized and outstanding on the books of Equity" (App. 26a).

On March 3, Arnold sent a letter to Mallis, a dentist, whereby Arnold confirmed his understanding and agreement with Mallis (App. 157a). The agreement provided (App. 157a):

> "The shares are to be held as collateral by you. It is agreed that within thirty days, or less, you (Mallis) shall be reimbursed the funds advanced by you, plus a profit of fifty (50,000.00) thousand dollars for your participation in this trade. Upon the remittance to you of your investment plus fifty thousand dollars you will deliver the shares to Jack H. Arnold free of any encumbrances.
>
> There is currently pending a transfer pursuant to a written option a block of 100,000 shares of Merck & Co., Inc., out of which proceeds you will be reimbursed for the total sum of money accruing to you. This transfer will be completed during March, 1972."

Since the stock had been hypothecated to Bankers, the stock could not be sold by Kates until after it had been returned to Kates. Bankers was informed by Kates that Kates had obtained a purchaser for the Equity stock which he had given to Bankers as collateral for its loan (App. 135a). For the convenience of the parties, a closing was arranged for March 3, 1972 whereby the stock previously

pledged by Kates to Bankers would be released by Bankers and returned to Kates when the indebtedness of Kates was repaid (App. 135a, 126a).

The closing was held at Bankers' offices. Present at the closing were Kates, Arnold and Fowler, John A. Murfitt, an Assistant Vice President of Franklin National Bank, and Nathan Silverman, an attorney representing Bankers (App. 135a). Since the agreement had been consummated between Arnold and Kates on February 24 (App. 25a-27a) Bankers' attorney merely stood on the sidelines while the closing took place (App. 135a, 129a-130a). The stock certificates were exhibited at the closing and contained the following legend (App. 135a, 32a, 36a):

> "The shares evidenced by this certificate are subject to the provisions of an Escrow Agreement dated August 7, 1970 among the Corporation, Equity Take-Two, Inc., The National Bank of Georgia and Stanley C. Lesser as nominee for the former shareholders of Take-Two, Inc., and may not be sold, transferred, pledged or hypothecated except in accordance with such Escrow Agreement, a copy of which may be examined at the office of the Corporation."

To consummate the closing Murfitt delivered three checks to Kates including one check in the amount of $45,000 (App. 136a, 127a, 28a-30a). When Murfitt originally drew check 773584 to the order of Kates and Bankers, Bankers' attorney refused to accept this check since Bankers was not involved in any dealings between Kates and his purchasers and accordingly insisted that the name of Bankers as copayee be stricken from the check. This was done and initialed by Murfitt (App. 127a, 30a). The check was then issued directly by Franklin to Kates. Kates then endorsed the check over to Bankers whereupon Bankers released and returned to Kates the previously pledged stock certificates evidencing 40,384 shares of Equity (App. 136a, 127a).

The Instant Case

Subsequent to this transaction, Bankers has been bombarded by a barrage of litigation from the various parties to this action.

On March 8, 1972, soon after the closing, Equity served a Summons and Complaint against Bankers seeking the return of the securities. This action was discontinued against Bankers by Stipulation (App. 179a-180a). Equity subsequently instituted another action against the various other defendants in the Delaware Courts to which Bankers was not a party (App. 37a-42a).

On December 11, 1972, Mallis instituted an action against Bankers as well as other defendants in the State Court (App. 138a-150a). That action was dismissed by Justice Nadel in July 1973 (App. 167a-170a, SA. 10a-11a) and that decision is the basis for Bankers' argument of collateral estoppel in this case. Ignoring the agreement of February 24 (App. 25a-27a), on December 13, 1973, Arnold issued a third-party complaint against the various defendants including Bankers, asserting that Bankers caused to be prepared an affidavit by Kates—knowing that such affidavit was false—and sought judgment over against Bankers (SA1-9). That action is still pending in the State Courts.

The original action instituted by Mallis against Bankers alleged that Bankers was fully aware that the stock was restricted and worthless and that Bankers aided and assisted the conspirators in foisting off worthless collateral. Paragraphs 17 and 18 of the original complaint read as follows (App. 142a):

> "Seventeenth: That upon information and belief, at all of the times herein mentioned, and at the time of such closing, the defendant 'Bankers', its agents,

servants and employees were fully aware that the restrictions on the sale of said stock were in full force and effect, the escrow agreements fully binding and conclusive on the parties thereto, and that the defendants 'Kates' had no legal right to sell, transfer or assign such stock certificates free and clear of encumbrances, but remained silent, and failed to disclose such knowledge to the plaintiff or his representatives.

Eighteenth: That upon information and belief, the defendant 'Bankers' aided and abetted the conspiracy and swindle, for the purpose of securing the repayment of its loan from the defendants 'Kates' and for that reason assisted the conspirators in foisting off worthless collateral consisting of stock certificates #U1828 and #U1833 upon the plaintiff, by its silent acquiescence and participation in the closing which took place at its office, and its acceptance of the 'investment' of plaintiff or a portion thereof in liquidation of its loan to 'Kates'".

The complaint further alleged in its sixth cause of action that (A pp. 148a-149a):

"Forty-fourth: That the defendant 'Bankers', anxious to receive from defendants 'Kates' the repayment of its loan foisted off upon the plaintiff the worthless 40,384 shares of restricted 'National' stock, which it had held as collateral from 'Kates' to secure said loan, and wrongfully and fraudulently concealed from plaintiff and 'Arnold' that the collateral was restricted and limited as to its negotiability, assignability and transfer, and was substantially worthless.

Forty-fifth: That further practicing such fraudulent concealment, the defendant 'Bankers' its agents, servants and employees at the closing of the transaction silently and without disclosure permitted and

allowed the defendants 'Kates' to deliver an affidavit to the defendant 'Arnold', to the effect that the aforesaid stock certificates were free and clear of any restrictions or limitations on negotiability, transfer or assignment.

FORTY-SIXTH: That continuing to practice said fraudulent concealment the said defendant 'Bankers' its agents, servants and employees made no effort to inform the defendant 'Arnold' of the falsity of said statement of the defendants 'Kates' but on the contrary aided, abetted him and consented to such deception by remaining silent, despite its prior knowledge and notice that the aforesaid representations of 'Kates' were false and fraudulent and that the monies of the plaintiff were to be paid over in reliance thereon.

FORTY-SEVENTH: That in further pursuance of such fraudulent concealment, the defendant 'Bankers' at such closing accepted the plaintiff's monies in liquidation and repayment of 'Kates' loan from the defendant 'Bankers', although its officers and agents then were aware that such monies were being advanced against worthless stock of 'National', all to the damage of the plaintiff in the sum of $156,728, with interest from the 3rd day of March 1972."

On motion to dismiss Justice Nadel granted the motion dismissing the complaint with respect to Bankers. Justice Nadel stated (App. 169a-170a):

"Bankers Trust is likewise charged with the same duty to speak for the protection of plaintiff Equity National Industries, Inc. and is charged with both fraud and negligence in permitting 'escrowed stock' into the possession of defendant Kates, thereby allegedly aiding and abetting in the swindle.

Plaintiff is proceeding under several fallacies with respect to facts. The Escrow Agreement sets up two classes of shares, conditional shares which were issued to the stockholders of the company being acquired subject to recall if certain profits were not realized, and final shares, which were held by the escrow agent until the number of final shares to be exchanged for conditional shares could be determined. The conditional shares and a restrictive legend placed on both face and back of each certificate. The restriction did not per se make the stock 'worthless' as plaintiff contends. Equity National did not allow 'escrowed shares' to circulate. These were final shares under the terms of the Escrow Agreement, which plaintiff could have determined from the National Bank of Georgia, the escrow agent, as well as transfer agent, if he had taken the precaution of examining the stock certificates.

The leading case on where there is a duty to speak is *Amend* v. *Hurley,* 293 N.Y. 587, which holds that barring a fiduciary or confidential relationship there is no duty to speak. Plaintiff had absolutely *no* relationship with defendants London, Bankers Trust or Equity National. He was not even a purchaser of the shares, according to his letter arrangement with Arnold. No matter what he chooses to call his participation in this 'investment', the Equity shares are called 'collateral' and he is guaranteed *repayment* out of another stock transaction.

The 'fraudulent concealment' he alleges against these defendants must fall on the basis of plaintiff's own exhibits in opposition to those motions. The legend showing a restriction on the sale or hypothecation of the shares appears on the face and back of both stock certificates. The court is unable to determine when or how plaintiff could or should have been informed by these defendants, who could not and did not know of his existence prior to the closing when he did not attend."

An order of dismissal was entered on August 1, 1973 (SA10-11). No appeal was taken from that order.

ARGUMENT

I. Mallis clearly lacks standing to maintain a Cause of Action under the Securities and Exchange Act against Bankers, since he plainly did not satisfy the Birnbaum purchaser-seller requirement, recently reaffirmed by the Supreme Court in Blue Chip Stamps.

Judge Pollack correctly ruled that Mallis and Kupferman as pledgees, had no standing to bring this action against Bankers, since Mallis[3] was neither a purchaser nor a seller of securities as required by the Birnbaum doctrine, *Birnbaum* v. *Newport Steel Corp.*, 193 F.2d 461 (2d Cir. 1952), recently adopted by the Supreme Court in *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723 (1975). Neither the pledge of the securities by Kates to Bankers in 1970 and the concomitant return of the pledged stock to Kates by Bankers in 1972, nor the acceptance of the pledged stock as collateral by Mallis from Arnold, bring this transaction within the scope of the Federal Securities Laws. Judge Pollack correctly recognized (App. p. 185a) that "[t]he mere acceptance of a stock pledge as collateral in a privately negotiated transaction between borrower and lender does not of itself bring a transaction within the scope of the federal securities laws." citing *McClure* v. *First National Bank of Lubbock, Texas*, 497 F.2d 490 (5th Cir. 1974), *cert. denied* 43 U.S.L.W. 3449 (1975) and *Rosen* v. *Dick*, CCH Fed. Sec. L. Rep. 94,786 (S.D.N.Y. Sept. 3, 1974).

In *McClure* v. *First National Bank of Lubbock, Texas*, the Fifth Circuit expressly held that the pledge of stock by Mrs. McClure in consideration for the banks renewal of a

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[3] For the convenience of the Court, the plaintiffs are collectively referred to throughout this brief as Mallis.

loan was not a sale of securities, protected by the anti-fraud provisions of Section 10B of the Securities Act. The Court reasoned (497 F.2d at 490):

> "The securities acts have as their fundamental purpose the protection of investors. To this end they are designed to 'substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus achieve a high standard of business ethics in the securities industry.' Affiliated Ute Citizens v. United States, 406 U.S. 128, 151, 92 S.Ct. 1456, 1471, 31 L.Ed.2d 741 (1972), quoting SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186, 84 S.Ct. 275, 11 L.Ed.2d 237 (1963). A commercial bank in accepting a pledge of stock as additional consideration for the extension of an overdue commercial loan does not necessarily affect the securities industry. A commercial bank's business is lending money not trading in securities. *Cf.* Bronner v. Goldman, 361 F.2d 759 (1st Cir.), cert. denied, 385 U.S. 933, 87 S.Ct. 295, 17 L.Ed.2d 214 (1966) (factor selling pledged stock not a 'broker' or 'dealer'). If the bank sells stock pledged as loan collateral, it might than be subjected to liability in connection with the sale if it does not meet the requirements of the anti-fraud provisions of the securities acts, but mere acceptance of a stock pledge as collateral in a privately negotiated transaction between borrower and lender does not, of itself, bring within the scope of the federal securities acts a transaction otherwise outside their purview. *See* 1 L. Loss, Securities Regulation 649 (2d ed. 1961).
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> * * *
>
> [I]n this case the Bank did not foreclose on Mrs. McClure's pledged stock and did not sell it. Title to it remains in Mrs. McClure. Under these circumstances, her pledge did not constitute a 'sale' of her stock within the meaning of section 10(b) of the 1934 Act and of Rule 10b-5."

Similarly in *Rosen* v. *Dick*, CCH Fed. Sec. L. Rep, 94,786 (S.D.N.Y. Sept. 3, 1974), Judge Metzner held that the mere pledge of stock would not satisfy the purchase or sale requirement of the *Birnbaum* rule.

These decisions are plainly consistent with the legislative history of the act as well as the commentators on the rule. The Act as noted in 1 Loss, Securities Regulations (2d Ed. 1961) 645 at Footnote 13:

> "The act as introduced and as passed by the Senate expressly exempted sales 'by or for the account of a pledge holder or mortgagee selling or offering for sale or delivery in the ordinary course of business and not for the purpose of avoiding the provisions of this Act, to liquidate a bona fide debt, a security pledged in good faith as collateral for such a debt.' " H.R. 4314 and S.875, 73d Cong., 1st Sess. (1933) 12(b).

Loss noted that the elimination of this section in the final Bill does not seem too significant, because in many instances the exemption in the original bills for isolated transactions by non-dealers (12(c)), which was narrower than the first clause of 4(1) as adopted, would not have extended to liquidating transactions by a pledgee.

Similarly, the early commentators on the Act including Allen E. Throop, who was Assistant General Counsel of the Commission from September 1934 and General Counsel after January 15, 1937, pointed out that a specific exemption with respect to transactions of liquidation by a pledgee was not included in the Act because it was unnecessary. Throop concluded:

> "*A fortiori,* the bona fide pledgee who distributes only because forced to do so by the default of the issuer or its affiliate should not be prevented from doing so by reason of the unwillingness of the issuer or its affiliate to effect registration."

Throop and Lane "Some Problems of Exemption under the Securities Act of 1933," 4 *Law and Contemporary Problems*, 89, 124-125, Note 103.

Indeed the Commission itself has recognized the validity of the contention that a pledge of collateral is not a sale when the pledge was intended to be a bona fide pledge and in good faith. Thus the commission itself has held that a registration of pledged securities was unnecessary where the pledge was in good faith and bona fide. In an interpretive letter of August 1, 1973, CCH Paragraph 83, 361, Federal Securities Law Report and reproduced in Goldberg "Private Placements and Restricted Security" at Page 2.52, the Commission Staff stated:

> "It is anticipated that the Japanese Purchasers will pledge their shares to secure bank loans, the proceeds of which will be used to purchase the Company's stock. The lending institutions involved are permitted to dispose of the shares in the event that the Japanese Purchasers default on their repayment of the loans. You state that you do not consider the resale potential as a significant factor since the size and prominence of the Japanese Purchasers makes it highly unlikely that they would default on their repayment obligations."

The determination by the administrative agency which interprets the law that a pledge of unregistered stock is not a sale for purposes of the Act where the pledgee bank accepted the stock in good faith and is a bona fide pledgee is plainly entitled to great weight. The agency recognizes that the pledge of unregistered stock as loan collateral becomes a "sale" only if the pledgee unknowingly accepts the securities with the knowledge that it is going to foreclose on the securities and distribute the securities to the public at large.

Ignoring the good faith and "bona fides" of the pledge, Mallis asserts that Goldberg states that the creation of pledgee interest in security will expand the scope of an

offering. (Brief, Page 14.) Mallis fails to point out that Goldberg concludes his comment with the observation that a pledge is a sale or device for disposing of securities only when the securities are pledged with the intent of defaulting on the loan, thus necessitating a sale by the pledgee to cover his loan, citing for example *SEC* v. *Guild Films Company,* 279 F.2d 485 CA2 (1960), Goldberg, *supra* at Page 2.52.

In the instant case, it is clear that Kates did not pledge the securities to Bankers with the anticipation that he would default on the loan and Bankers would sell the securities on the open market. Kates pledged the securities, made monthly reductions and ultimately repaid the entire indebtedness whereby he was able to redeem the securities that he had pledged to Bankers. Similarly, when Arnold pledged the securities, to Mallis (App. 157a) Arnold did not intend to renege on the loan but intended to repay the loan from a sale of other securities and likewise redeem the Equity securities from Mallis. In these circumstances it is plain that the pledge of securities in this case was in good faith and not intended as a device to place the securities on the open market by that transaction under the sale. The validity of this ruling that a pledge is not a sale and brings the pledgee within the purchaser-seller requirement of *Birnbaum* is demonstrated by the approval by the Court in *Blue Chip Stamps* (421 U.S. at 748) of *Herpich* v. *Wallace,* 430 F.2d 792, 812 (CA5 1970) where the guarantor of the pledger was held not a "purchaser" of pledged stock where there was, *inter alia,* no allegation of foreclosure. *Herpich* is plainly analogous to the instant case since the parties contend that "the pledge agreement was pretextual, disguising a purchase in substance by [the corporation] of [the defendant majority stockholders] worthless stock." 430 F.2d at 811.

Totally ignoring these decisions and the legislative history, Mallis seeks to circumvent the *Birnbaum* rule by

asserting that cases such as *Supt. of Insurance* v. *Bankers Life and Casualty Company,* 404 US 6 (1971) make unnecessary the purchase and sale of securities to bring him within the Act (Brief at Pages 11-12). In so doing, he ignores this Court's decision, in *Frigitemp Corp.* v. *Financial Dynamics Fund,* 524 F.2d 275 at 280 wherein this Court stated:

> "This court has interpreted Bankers Life to mean that the *Birnbaum* rule remained intact, noting that *Bankers Life* 'in no way suggested a rejection of the rule that a plaintiff under Section 10(b) must be a party to the sales transaction.' *Haberman* v. *Murchison,* 468 F.2d 1305, 1311 n. 5 (2 Cir. 1972). In *Blue Chip Stamps,* the Supreme Court held that an offeree who failed to buy the stock offered because of an allegedly fraudulent prospectus had no standing to sue under 10(b) and 10b-5 since he was neither a purchaser nor a seller. It did not analyze the *Bankers Life* opinion except to approve the gloss put upon it by the Second Circuit in *Haberman* v. *Murchison,* 732 U.S. at 421, 95 S.Ct. at 1923."[4]

In his brief, Mallis asserts that this Court has not passed upon question as to whether or not a pledgor has standing to assert a claim under Rule 10(b)-5 by references to *Dopp* v. *Franklin National Bank,* 461 F.2d 873, Note 13 at 878 (Mallis brief Page 14). In so doing, he ignores, and correctly so, the earlier cases decided by this Court: *SEC* v. *Guild Films, Company,* 279 F.2d 485 (2nd Cir.) *cert denied sub nom, Santa Monica Bank* v. *SEC,* 364 U.S. 819. In *U.S.* v. *Gentile,* 530 F.2d 461 (CA2 1976) this Court

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[4] The Court in *Haberman* observed that *Bankers Life* "in no way suggested a rejection of the purchaser seller-requirement. The Court made clear that 'Manhattan (the injured party) was the seller of Treasury bonds and it seems to us clearly protected by 10(b). . . . The Act protects corporations as well as individuals who are *Sellers* of a security. 404 U.S. at 9, 10.' "

held that a pledge of securities to a bank was a sufficient sale of securities to subject the fraudulent pledgor to criminal violations. The pledgor there had issued unauthorized certificates in his own name and either sold them on the over the counter market or pledged them to banks as collateral for loans which they had no intention of redeeming (530 F.2d at 464). In that context, this Court held that the pledge of securities was a sale relying on the *Guild Films* decision, disagreeing with the Fifth Circuit decision in *McClure* (530 F.2d at 466-467). Gentile is plainly distinguishable from the instant case at bar. *Gentile* was a criminal prosecution, and, as noted by the Court, there was plainly no bona fide pledge of the securities. Indeed, this was the gravamen of the proceeding against the defendants. The pledgee did not intend to redeem the fraudulently issued securities from the bank. A criminal prosecution is plainly different than a 10b action. See Jacobs, *The Impact Act of Rule 10b-5* (1974), 38.01(d), 3-25, 2-35, fn.s 8 and 9. "The *Birnbaum* doctrine was undoubtedly intended as a standing rule only for private rights or action." *Ibid.* at 3-25. The U.S. Government need not be a purchaser or seller to start a criminal proceeding. Similarly, a defendant in a criminal action (as distinguished from a plaintiff) need not satisfy the purchaser-seller requirement. Jacobs, "Standing to Sue Under 10b-5 After Blue Chip Stamps," 3 *Securities Regulation Law Journal* (Winter, 1976), 387, 408. Second, the defendant in *Gentile* was a pledgor of securities. Mallis on the other hand was a pledgee unconnected with Bankers. *Gentile*, therefore, is easily distinguishable. This construction is plainly consistent with both the courts and the commentator since this court's decision in *Guild Films*. Mallis apparently agreed with this distinction by its references to the fact that no decision existed to hold that *Dopp* had standing to assert a claim (Brief, page 14).

In *Blue Chip Stamps*, 421 U.S. at 747-748 and the more recent decision in *Ernst & Ernst* v. *Hochfelder*, —— U.S.

——, March 30, 1976, Slip Opinion at Page 28, Note 33, the Court aptly observed:

> "While much of the development of the law of deceit has been the elimination of artificial barriers to recovery on just claims, we are not the first court to express concern that the inexorable broadening of the class of plaintiffs who may sue in this area of the law will ultimately result in more harm than good. In *Ultramares Corp.* v. *Touche,* 255 N. Y. 170, 174 N. E. 441 (1931), Chief Judge Cardozo observed with respect to 'a liability in an indeterminate amount for an indeterminate time to an indeterminate cause':
>
> " 'The hazards of a business conducted on these terms are so extreme as to enkindle doubt whether a flaw may not exist in the implication of a duty that exposes to these consequences.' *Id.*, at 179-180, 174 N. E., at 444."
>
> This case, on its facts, illustrates the extreme reach of the standard urged by respondents. As investors in transactions initiated by Nay, not First Securities, they were not foreseeable users of the financial statements prepared by Ernst & Ernst. Respondents conceded that they did not rely on either these financial statements or Ernst & Ernst's certificates of opinion. See n. 9, *supra*. The class of persons eligible to benefit from such a standard, though small in this case, could be numbered in the thousands in other cases. Acceptance of respondents' view would extend to new frontiers the "hazards" of rendering expert advice under the Acts, raising serious policy questions not yet addressed by Congress.

See also *Woodward* v. *Metropolitan Bank of Dallas*, 522 F. 2d 84 (CA 5 1975).

This case is plainly the precise type of situation which the Court in both *Blue Chip Stamps* and *Ernst & Ernst*

sought to preclude. Justice Pollack correctly recognized (App. 186a):

> "there was no purchase by plaintiffs in this case. Plaintiffs loaned the funds to Arnold and Fowler, who had already contracted to buy the stock in question. While the stock later came into plaintiffs' possession as collateral for their loan, the consideration for that loan was the obligation by Arnold and Fowler to repay with a bonus. Attempts to characterize the transaction as a purchase of the stock by plaintiffs are not convincing. To allow persons in plaintiffs' situation to sue under Rule 10b-5 would be to expand the class of prospective litigants under the rule to an extent uncalled for by words of the rule or the statute. *Cf. Bolger* v. *Laventhol, Krekstein,* Horwath & Horwath, 381 F. Supp. 260, 267 (S.D.N.Y. 1974)."

II. In any event, Mallis is precluded from relitigating in Federal Court the identical issues decided against him in the State Court action by Justice Nadel.

As we have shown, soon after the closing on March 3, 1972, Mallis instituted an action in State Court arising out of this same transaction against Bankers, *supra* Pages 8-9, App. 138a, 150a. After extensive pleadings and briefings (App. 131a-170a, S.A. 10a-11a), Justice Nadel dismissed the complaint. Mallis is seeking to retry these identical issues against Bankers by asserting an alleged Securities Act violation.

Such an action is precluded by the decisions of this Court. *Abramson* v. *Penwood Investment Corporation,* 392 F.2d 759 (CA2, 1968). In *Abramson* where a complaint alleged a 10b violation after an earlier dismissal of a complaint in a State Court action, this Court reasoned that "where both the State and Federal issues are based upon the same transaction, collateral estoppel would apply

with regard to the facts determined in the state action," (392 F.2d at 762). Justice Nadel in his opinion of July 13, 1973 held that (App. 170a):

> "Plaintiff had absolutely *no* relationship with defendants London, Bankers Trust or Equity National. He was not even a purchaser of the shares, according to his letter arrangement with Arnold. No matter what he chooses to call his participation in this 'investment', the Equity shares are called 'collateral' and he is guaranteed *repayment* out of another stock transaction.
>
> The 'fraudulent concealment' he alleges against these defendants must fall on the basis of plaintiff's own exhibits in opposition to these motions. The legend showing a restriction on the sale or hypothecation of the shares appears on the face and back of both stock certificates. The court is unable to determine when or how plaintiff could or should have been informed by these defendants, who could not and did not know of his existence prior to the closing when he did not attend."

These findings plainly establish Bankers freedom from any wrongdoing and the lack of any nexus between Mallis and Bankers. Such a nexus is required if Mallis wishes to bring a claim for relief under Rule 10b-5 which requires that acts in violation of Section 10 of the Securities and Exchange Act be

> "committed *in connection* with the purchase or sale of any security."

Justice Nadel settled any dispute with respect to these issues by his findings.

Mallis is seeking to retry these very same issues arising out of the same transaction in the Federal Court. This he cannot do. As noted in *Lowell v. Twin Disc, Inc.*, 527 F.2d 767 (CA2, 1975), where a party such as Mallis "had a full and fair opportunity to contest the issue

in the state court action, see *Schwartz* v. *Public Administrator,* 24 N.Y.2d 65, 298 N.Y.S.2d 955, 246 N.E.2d 725 (1969)", is precluded from suing on the same facts in federal courts. Since the Court made findings that there was no relationship and no wrongful acts by Bankers, Mallis is plainly collaterally estopped and the correctness of the conduct of Bankers has been established beyond permissible relitigation. Mallis asserts in his brief at page 15 that these findings are not binding, since the matter was decided by Justice Nadel on a Motion to Dismiss. The New York Court of Appeals in *Vavolizza* v. *Krieger,* 33 N.Y.2d 356, 352 N.Y.S. 2d 919, has held that an order made upon a motion provides such "judgment" as will bar relitigation under the doctrine of collateral estoppel, so long as the requisites of identity of issue and opportunity to contest are present.

Turning first to the question of the "identity of issue", it is abundantly clear that the issues of fraud and negligence in permitting "escrowed stock not in the possession of Kates to be issued" and allegedly aiding and abetting in the swindle were plainly resolved by Justice Nadel in his decision of July 13, 1973 (App. 167a-170a). Resolution of these issues are plainly decisive of the present action. Where the plaintiff Mallis in this case would be barred from bringing an action alleging that Bankers attempted to defraud him; certainly Kupferman whose rights are purely derivative from those of the original plaintiff cannot recover against Bankers.

Since Bankers has plainly established this element of collateral estoppel, the only issue remaining to be determined is whether or not the plaintiff had a full and fair opportunity to contest the matter. The burden of proof on this issue, of course, rests upon the plaintiff, the nonmovant party (*Schwartz* v. *Public Admin. of Co. of Bronx, supra*). The various factors which enter into a determination as to whether a party has had his day in court include the size of the claim, the forum of prior litigation, the use

of the initiative, the extent of litigation, competence and experience of counsel, availability of new evidence, indication of a compromise verdict, differences in the applicable law, and foreseeability of future litigation (*Schwartz* v. *Public Admin. of Co. of Bronx*, 24 N.Y.2d 65, 298 N.Y.S.2d 955). *See also*, *Vincent* v. *Thompson*, 361 N.Y.S.2d 282, pp. 295-298 (Sup. Ct., Nassau, 1974).

These criteria have plainly been satisfied in this case. In both the prior proceeding and the present proceeding the forum is identical and the amounts claimed in each proceeding are virtually identical. The initiative in both the present action and the prior proceeding are virtually identical. The initiative in both the present action and the prior proceeding as well as the burden of proof falls upon Mallis. In both instances Mallis' need to win was compelling. The extent of litigation is plainly complete. As pointed out, *supra* in *Vavolizza* v. *Krieger*, 33 N.Y.2d 356, an order made upon a motion provides such a judgment as will bar relitigation under the determination of collateral estoppel so long as the requisite of identity of issue and opportunity to contest are present. Thus the fact that the original matter was resolved by a hotly contested motion by Mallis is plainly conclusive in this case. There can be no question with respect to the competence and experience of Mallis' counsel. Mallis throughout this proceeding has had excellent representation. The court in an examination of the pleadings and memoranda can see first hand the high quality of Mallis' attorney and can confirm their obvious skill and acumen. Certainly, one cannot say Mallis' counsel was in any way imposed upon by the Bank's attorney in the prior litigation. There are no differences in the applicable law in the prior proceeding and the present action. Indeed, the present action was clearly feasible when the prior proceeding has been conducted. There is no indication of any compromised verdict in Justice Nadel's decision of July 13, 1973.

Finally, there is no "new evidence" before this Court that was not readily availablé and could not have been submitted to Justice Nadel.

Mallis asserts that the judgment in favor of Bankers should not be given conclusive effect, because the dismissal was allegedly obtained as part of a fraud (Brief p. 15). This contention is plainly contrary to the facts.

The critical documents in Mallis's case, *i.e.*, the agreement between Arnold and Kates (App. 25a to 27a, 158a), the option contract (App. 159a), the stock certificates (App. 161a-162a, 31a to 36a), the affidavit of Jerome B. Kates (App. 163a) were all submitted by Mallis and his attorney to Justice Nadel in opposition to Bankers motion to dismiss (App. 152a to 163a). The fact that Bankers had a judgment against Mr. and Mrs. Kates, as a result of a workout arrangement, was a matter of public record (App. 282a). Certainly where all these facts were before the Court and on public record, it cannot be asserted that there was any fraudulent acts by Bankers in obtaining the judgment of dismissal against Mallis. In these circumstances, the Court must conclude that collateral estoppel should be applied in this case. The principal purpose of this rule is to insure that parties such as Bankers should not be consistently harassed by continued litigation as here in a matter once it has been resolved.

CONCLUSION

For any of the reasons stated, the order of the District Court dismissing the complaint should be sustained.

Respectfully submitted,

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